Notes by Steve Carr [www.houseofcarr.com/thread]

BOOK
An Economist Walks into a Brothel: And Other Unexpected Places to Understand Risk

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SYNOPSIS [from the publisher]
Whether we realize it or not, we all take risks large and small every day. Even the most cautious among us cannot opt out--the question is always which risks to take, not whether to take them at all. What most of us don't know is how to measure those risks and maximize the chances of getting what we want out of life.

In *An Economist Walks into a Brothel,* Schrager equips readers with five principles for dealing with risk, principles used by some of the world's most interesting risk takers. For instance, she interviews a professional poker player about how to stay rational when the stakes are high, a paparazzo in Manhattan about how to spot different kinds of risk, horse breeders in Kentucky about how to diversify risk and minimize losses, and a war general who led troops in Iraq about how to prepare for what we don't see coming.

"The revolutionary idea that defines the boundary between modern times and the past is the mastery of risk: the notion that the future is more than a whim of the gods and that men and women are not passive before nature."
—PETER BERNSTEIN, AGAINST THE GODS

"I don't seek out adrenaline-charged situations. I've never bungee jumped, I don't ski, and I may be the only New Yorker who is afraid to jaywalk. Rather than look for risky situations for the rush of defying the odds, I search for unusual places that can teach me more about risk and how to manage it."

"When people hear the word "risk," they automatically think of something terrible, the worst-case scenario, like losing their job, their wealth, or their spouse. But we need to take risks to make our lives better. We must gamble to get what we want, even if it comes with the possibility of loss."

"If we want a great relationship, we risk heartbreak. If we want to get ahead at work, we have to volunteer for projects that we might fail at. If we avoid risk, our lives won't move forward. Technically, risk describes everything that might happen—both good and bad—and how probable each of these outcomes is."

“Even the history of the word “risk” illustrates our complicated feelings about the concept: it derives from rhizikón, an ancient Greek seafaring term that describes a dangerous hazard.”

“Whether you realize it or not, you take risks large and small, every day, in all parts of your life. The good news is that you don’t have to leave it all up to chance and hope for the best. This book will show you how to mindfully take a risk and minimize the possibility that the worst will happen.”

“We can’t guarantee a positive outcome, but when we think about risk more strategically we can increase the odds that things will work out.”

“The science of risk I’m referring to comes from financial economics.”

“Risk in finance is an estimate of everything that might happen to an asset—say, the odds of a stock going up 2 percent or 20 percent, or dropping 60 percent. Once risk is measured it can be bought or sold: people can choose to increase risk or reduce it, according to their preference. Financial economics studies risk in financial markets, but its lessons can be applied to any market or decision we encounter in our lives.”

“I have a PhD in economics, but I didn’t learn much about finance until I finished graduate school. I had assumed financial economics was simply the study of how people try to beat the stock market to get rich. While that’s part of it, because increasing risk offers the possibility of making more money, financial economics is more than that: it is the study of risk.”

“The economics of risk are everywhere. When writing this book, I did something economists rarely do. Rather than sit at my desk at home and just look at data, I spent many hours in the company of noneconomists, far from Wall Street, and asked them how they manage risk in their lives and careers.”

“In most areas of economics, value is based on scarcity. It doesn’t work quite the same way in financial economics. Financial economics assumes risk is also a critical component of value. Goods that lessen risk tend to cost more. This critical piece of information can revolutionize the way you assess everyday decisions and help you make better, more informed choices.”

“You may not realize it, but when you buy the cheapest ticket, you are at the top of the list to be bumped if the airline oversells the flight—check out the fine print. A cheap ticket comes with the risk of being forced to miss your flight. Purchasing a more expensive ticket reduces that risk.”

“When we’re able to isolate risk in a transaction and determine how it is valued, we can make better decisions. Finance uses many technical tools to identify, price, and sell risk, but the basic ideas behind them are easy to understand and apply to any market or problem.”

“Policymakers, journalists, and academics often complain about people’s inability to understand risk. We are in fact prone to behaviors that cause us to distort the risks we face, and because of this we sometimes make choices that aren’t in our best interest.”

“We all have the potential to be great risk strategists, but few of us are taught how to practice risk analysis in our decision making.”

“The single most effective way to increase the odds that risk taking will pay off is fairly simple: define what risk and reward mean to you. The biggest mistake people make when they take a risk is not having a well-defined goal.”

“How we perceive risk is often not based on objective probabilities; rather, it depends on how risk is presented to us. We sometimes assume certainty when there is none, or that something unlikely is probable.”

“A bigger risk doesn’t always mean more reward. Sometimes we face two options that offer the possibility for the same expected reward, but one is riskier than the other. Taking more risk than necessary is inefficient.”

“One strategy to minimize risk is hedging. Hedging protects you from losing by a counterbalancing action, trying to strike a balance between risk and safety.”

“The other method to reduce risk is insurance, where you pay someone else to bear downside risk for you. Unlike hedging, after you pay for insurance, you keep all the potential upside.”

“Risk management reduces the odds the worst will happen, but it also creates a new downside. Any tool that reduces risk can also be used to enhance it; a safety net can either catch you when you fall or be used as a slingshot to catapult you higher. The same is true for hedging and insurance. Not only that, reducing risk can embolden more risk taking and result in using extra leverage to take even bigger risks.”

“Risk estimates everything we think might happen, but there are also all the things we never imagined could happen—the difference between risk (what can be estimated) and uncertainty (the things we never anticipate). Things you don’t expect always come up, and you can prepare for the unexpected.”

“From a risk perspective, there has never been a better time to be alive. For most of human history we regularly faced truly catastrophic risks like famines and plagues. Take an easy decision that most of us wouldn’t think twice about today, like going to visit a friend in a different city. In the past, you might have exposed yourself and your family to a horrible, deadly disease by taking that trip. These days, if you live in a rich, stable country, those risks are highly unlikely.”

“But our modern selves face more acute risks that threaten our way of life. With the economy going through a major transition, no one’s job seems as safe and certain as it once did.”

“More data offers the potential to measure risk more accurately, and technology helps us interpret that data in seconds to be able to make quick decisions. Often, we can do this from our phones: Waze minimizes the risk of being stuck in traffic; Netflix increases the odds of watching a movie you’ll love; travel websites can predict whether the price of a flight will go up or down.”

“Using a road map doesn’t guarantee a safe journey. The map probably doesn’t include the tree you might smash into because you were texting while driving. It also doesn’t include the Mack truck that might accidentally slam into you even if you drive safely. But that does not mean you should throw out the map.”

“The one thing they all have in common is risk. None of these people have ever worked on Wall Street, but they use the same strategies financiers use to manage risk. Their stories illustrate how the lessons of finance can help us all navigate the modern economy.”

“A risk is more likely to work out if you are seeking a reward you actually want. It sounds so obvious, but we often take risks just because we want change. And when we do that, we often lose, no matter what happens.”

“Taking a risk without a goal is just like getting in a car and driving around aimlessly expecting to wind up in a great place. You might land somewhere wonderful, but odds are you’ll end up somewhere you don’t want to be.”

“While financial economics is no substitute for good therapy, it offers a method that can help define your goal, which, more than anything else, will increase your odds for a more successful outcome. This three-step process offers clarity and helps assess how much risk you might want to take to reach your goal. What is your ultimate goal? If you achieve it, what does that look like? How can you achieve your goal with no risk at all or as little risk as possible? In other words, what would guarantee you would accomplish your goal? Is that no-risk option possible or desirable? If not, how much risk do you need to take to get what you want?”

“Risk-free looks different to each person, which is why figuring out what’s risk-free for you provides clarity and helps you value risk. Simply articulating what you want and setting that as a goal is an extremely powerful tool.”

“Learning how to define your goal and price it in risk-free terms is the foundation of any good risk strategy. But what happens when we don’t want to choose the risk-free option? Maybe it is too expensive, or we crave more risk and the possibility of more reward.”

“Smart risk taking involves going for more, and taking just enough risk that we need to, or are comfortable with, to achieve our goal.”

“Conventional wisdom in the financial industry is to build up as much wealth as possible (the trust-fund strategy) and then to spend a certain percent, say 4 percent, each year once you retire. But the 4 percent per year isn’t a fixed amount—the actual amount you receive depends on what’s happening in the stock market. That’s where the strategy goes wrong. A predictable salary, like the one you earned when you were working, should be the goal of your retirement fund. Most workers wouldn’t accept a salary that varies with stock prices—why should retirees?”

“It does not offer any certainty about how much you can actually spend each year, because you can’t predict how long you will live or what the market will do to your savings during retirement.”

“Il n’est pas certain que tout soit incertain. (It is not certain that everything is uncertain.)”
—BLAISE PASCAL, PENSÉES

“Risk is the opposite, all the things that might happen and the odds that they will. In a perfect world, we have a risk estimate that captures all possible outcomes and puts precise odds on each one happening. But the world is full of uncertainty, and we lack the imagination to anticipate everything that could go wrong (or right) and rarely know the exact odds of anything.”

“Sometimes it is easy to make an accurate estimate; at other times risk measurement is nearly impossible. When it comes to the challenges of measuring risk, I can think of no better example than the movie business.”

“People in the movie business explain that it is impossible to predict what will be a blockbuster or a flop. Each film is like a small business with hundreds of moving parts. The only way to manage risk is to make lots of movies; most won’t make money, but a few will hit it big and pay for the others. This is a risky way to run a business, and it also explains why there are so many bad movies, with terrible, derivative plots, that fail at the box office.”

“Studios scramble to reduce financial risk by securing financing from outsiders to take on the risk for them. Attracting these investors often involves piggybacking off the latest fad, signing a megastar to the project, or seeking the potential for merchandising revenue.”

“To offset the risk, deals are often made for a slate of about a dozen movies at a time, but investors often cannot choose which films are included in the slate.”

“If you drive to the same airport once a month, odds are it does not take exactly thirty-three minutes each time. More likely, it usually takes between twenty and forty minutes, depending on traffic or weather. That range doesn’t account for something unusual

happening, like a terrible accident that causes an hour’s delay. In general, we make a decision based on the normal range of things that might happen. If we are prudent, we assume it will take forty minutes to get to the airport; if we can tolerate a little risk, we might only allow for thirty minutes.”

“Risk is our guess about what the future holds; more precisely, it is the range of things that might happen and how probable each event is.”

“But that’s the thing about predicting the future based on the past. It works until it doesn’t, because the market (especially for movies) keeps changing, and estimates based on old data no longer tell you much of anything; what is difficult is knowing when you need to update your data. Often we don’t realize the world is changing until long after it has changed.”

“Stale data undermines more than predicting which movies will break box office records. Voting patterns from the Obama/Romney election weren’t relevant for making inferences in the Trump/Clinton election, which resulted in misleading poll projections. Technology and more global trade alter old economic relationships and make past data less relevant today.”

“Data may be a terrible way to predict the future, but it is the best we’ve got because it is all we have. The limitations of data are in some ways becoming more apparent in a rapidly changing world that renders past data useless in an instant. At the same time, data is becoming a more powerful tool to measure risk. The modern world is taking the original ideas of Pascal, Fermat, and Bernoulli even further because now we have more and better data, with more computing power to measure risk than ever before.”

“Financial economists separate risk into two broad categories: the first is idiosyncratic risk, or the risk unique to a particular asset. Suppose Facebook changes management; the future of the company is unclear, and the price of the stock might drop based on factors unique to Facebook that don’t impact any other stock.”

“The second kind of risk is systematic risk, or risk that affects the larger system instead of an individual asset. Systematic risk is when every stock rises or falls together because the entire market surges or crashes, as it did in 2008. Systematic risk events often happen because of a big economic disruption like a recession or an election result that people think will impact business.”

“We want to think we’re rational beings. And for the most part, we are. But perhaps the most obvious place to witness our irrationality at work is when we make a risky decision. This is when human nature gets in the way, and sometimes we make choices we later regret. Don’t fear: you can learn about the underpinnings of irrationality at work, what’s likely to trigger it, and how to avoid these traps to make better decisions more often.”